**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS: 04-0118**
**Indiana Corporate Income Tax**
**For 1999, 2000, and 2001**

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## ISSUES

**I. Money Earned from Licensing Computer Software to Indiana Customers** – Adjusted Gross Income Tax.

**Authority**: IC 6-3-2-2(a); Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291 (5th Cir. 1980); RRX Indus., Inc. v. Lab-Con, Inc., 772 F.2d 543 (9th Cir. 1985); Colonial Life Ins. Co. v. Electronic Data Sys. Corp. 817 F.Supp. 235 (D. N.H. 1993); South Cent. Bell Tel. Co. v. Barthelemy, 643 So.2d 1240, 1246 (La. 1994); American Business Information Inc. v. Egr, 650 N.W.2d 251 (Neb. 2002); Black's Law Dictionary (7th ed. 1999).

Taxpayer maintains that the Department of Revenue (Department) erred when it determined that money it earned from licensing computer software to Indiana customers should have been included in the numerator of the sales factor.

**II. Abatement of the Ten-Percent Negligence Penalty**.

**Authority**: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department abate the ten-percent negligence penalty.

## STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of creating and licensing computer software. Taxpayer also performs certain data processing services at its out-of-state location.

The Department conducted an audit review of taxpayer's income tax returns and business records. As a result of that audit review, the Department concluded that taxpayer had not properly reported a portion of its income. The audit made adjustments resulting in the assessment of additional state income tax.

Taxpayer disagreed with a number of the audit adjustments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer further explained the basis for its protest. This Letter of Findings results.

## DISCUSSION

**I.** **Money Earned from Licensing Computer Software to Indiana Customers** – Adjusted Gross Income Tax.

Taxpayer entered into agreements with Indiana customers which enabled the customers to make use of taxpayer's computer software. Taxpayer characterizes these as licensing agreements. The audit concluded otherwise finding that the taxpayer was engaged in the sale of tangible personal property and that the money attributable to the sales should have been included in the numerator of the sales factor. The audit arrived at this conclusion because taxpayer shipped the computer software to the Indiana customers by way of common carrier and because taxpayer – in its 10-K Report – stated that "revenue from licensing of software products is recognized upon shipment of the products . . . [the] shipped products would be tangible personal property and the income from tangible personal property shipped to Indiana customers would be included in the sales factor numerator." Taxpayer admits that it sent computer software to its Indiana customers by means of common carrier and that the Indiana customer received the software by way of a tangible object; taxpayer sent computer disks, the common carrier delivered the computer disks, and the Indiana customer received the computer disks. However, taxpayer maintains that computer disks are irrelevant in resolving the tax question and that the software could be transferred to the customer by way of a computer modem or some other non-corporeal means.

When an Indiana customer decides that it wants to make use of taxpayer's computer software, the customer signs a "License Agreement." This Agreement grants to the customer a "non-exclusive, non-transferable personal license to use the Software . . . ." Taxpayer retains the "[t]itle and full ownership rights to the software . . . ." The Indiana customer specifically "acknowledges and agrees that the Software is the property and contains the trade secrets of [taxpayer]." The Agreement limits the rights of the Indiana customer; the Indiana customer may only use the software on certain, designated computers. The Indiana customer is not permitted to make copies of the software except for its own internal use. The Indiana customer is required to "implement technical and procedural methods to prevent use of the Software other than as specifically authorized under [the Agreement]." Taxpayer points to the Agreement as supporting the proposition that the Indiana customer acquires only an insubstantial, intangible right to the software.

The issue is whether taxpayer is earning money from "tangible personal property" or from "intangible personal property." IC 6-3-2-2(a) states that, "With regard to corporations and non resident persons, 'adjusted gross income derived from sources within Indiana', for the purpose of this article, shall mean and include (1) income from real or *tangible personal property* located in this state; (2) income from doing business in this state . . . (5) income from stocks, bonds, notes, bank deposits, patents, copyrights . . . and other *intangible personal property* if the receipt form the intangible is attributable to Indiana under section 2.2 of this chapter." (*Emphasis added*). Therefore, IC 6-3-2-2(a) distinguishes between tangible personal property and intangible personal property for purposes of apportioning income to Indiana.

The Department is unable to agree with taxpayer's assertion that, "Revenue from the licensing of software is not from the sale of tangible personal property." Tangible personal property is defined as "Corporeal personal property of any kind . . . that can be seen, weighed, measured, felt, or touch, or is in any way perceptible to the senses." Black's Law Dictionary 1234 (7th ed. 1999). Computer software is not an insubstantial intellectual concept, "but rather is knowledge recorded in a physical form which has physical existence, takes up space on the tape, disc, or hard drive, makes physical things happen, and can be perceived by the senses." South Cent. Bell Tel. Co. v. Barthelemy, 643 So.2d 1240, 1246 (La. 1994). *See also* American Business Information Inc. v. Egr, 650 N.W.2d 251 (Neb. 2002) (holding that for purposes of the Nebraska apportionment statute, computer software was tangible personal property). The fact that the software information can be recorded or transferred from one medium to another does not alter the nature of the software acquired by the Indiana customer. "[The software] still has corporeal qualities and is inextricably intertwined with a corporeal object. The software must be stored in physical form on some tangible object somewhere." South Cent. Bell Tel. at 1248. Therefore, regardless of whether the software is transferred by means of disks, magnetic tape, hard drive, or modem, the software is a tangible object prior to delivery and is a tangible object when utilized by the Indiana customer. In this sense, taxpayer's transfer of the computer software to an Indiana customer is no different than the transfer of books, audio recordings, DVD's, or computer games which embody intellectual property but which are commonly treated as tangible personal property. This principle is consistent with the position of other courts which have held computer software to be goods subject to U.C.C. Article 2 governing the sale of goods. RRX Indus., Inc. v. Lab-Con, Inc., 772 F.2d 543, 546-47 (9th Cir. 1985); Earman Oil Co. v. Burroughs Corp., 625 F.2d 1291, 1293 (5th Cir. 1980); Colonial Life Ins. Co. v. Electronic Data Sys. Corp. 817 F.Supp. 235, 239-39 (D. N.H. 1993).

In addition, the fact that the agreement between taxpayer and its Indiana customers is couched in terms of a "License Agreement" limiting the Indiana licensee's right to use the software is not dispositive. "[A] license to use . . . software, without transferring the software, would be of no use to [taxpayer], and the license to use the software is inseparable from the physical manifestation of the software in recorded form." South Cent. Bell Tel. 643 So.2d at 1249.

The audit was correct in determining that the software was tangible personal property and the money earned from the marketing of that software to Indiana customers should have been included in the numerator of the sales factor for purposes of determining taxpayer Indiana adjusted gross income.

## FINDING

Taxpayer's protest is respectfully denied.

## II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer asks that the Department waive the ten-percent negligence penalty on the ground that it filed its original tax returns based upon a reasonable interpretation of the statutes and that any omissions or errors were not due to willful neglect.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

In regards to the 1999, 2000, and 2001 assessments, the Department agrees that taxpayer has demonstrated a reasonable basis for the positions originally taken.

## FINDING

Taxpayer's protest is sustained.

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